

D.T.E. 96-50-D

Investigation by the Department of Public Utilities/Department of Telecommunications and Energy on its own motion as to the propriety of the rates and charges set forth in the following tariffs: M.D.P.U. Nos. 944 through 970, filed with the Department on May 17, 1996, to become effective June 1, 1996, by Boston Gas Company; and investigation of the proposal of Boston Gas Company to implement performance-based ratemaking, and a plan to exit the merchant function.

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I. INTRODUCTION

In Boston Gas Company, D.P.U. 96-50 (Phase I) (1996) and Boston Gas Company, D.P.U. 96-50-C (1997), the Department of Telecommunications & Energy ("Department") established a performance-based regulation ("PBR") plan for Boston Gas Company ("Boston Gas" or "Company") to replace the traditional cost-of-service/rate-of-return ("COS/ROR") method for setting the Company's distribution rates.<sup>(1)</sup> Under the PBR plan, the Company's distribution revenue requirement and rates are recalculated annually: a "price-cap" formula takes into account the previous year's rate of inflation (which is intended to represent annual changes in the Company's costs) and the expected growth in productivity for the gas industry ("productivity offset").

The Department set the productivity offset equal to 1.5 percent.<sup>(2)</sup> The productivity offset included a 1.0 percent accumulated inefficiencies component, which the Department stated was necessary during the early years of the PBR plan to take into account the inefficiencies inherent in cost-of-service ratemaking.

The PBR plan also included a service quality adjustment mechanism, in which the Company's rates are adjusted downward if it does not meet the specified service performance standard in the service quality plan. The service quality plan included the following: (1) performance goals for seven service quality categories, based on Boston Gas' historic performance in the categories; and (2) a service quality adjustment provision if the Company falls short of the established goals. The Department established a

maximum annual service quality adjustment of \$4.9 million, \$700,000 for each service quality category.<sup>(3)</sup> The \$4.9 million constituted two (2) percent of the Company's distribution service revenue at the time the Order was issued.

The Company appealed the Department's Order to the Supreme Judicial Court, challenging (1) the inclusion of the accumulated inefficiencies factor in the productivity offset, and (2) the \$4.9 million maximum annual service quality adjustment. As to each issue, Boston Gas argued that the agency had (1) exceeded the Department's authority, (2) not based its findings on substantial evidence, and (3) not supported its findings with sufficient subsidiary findings.

In its brief to the Court, the Department agreed with the Company's argument that there were insufficient subsidiary findings. The Department, however, opposed the Company's position that (1) the Department did not have authority to impose an accumulated inefficiencies factor, and (2) there was not substantial evidence to support the Department's findings on accumulated inefficiencies and the service quality adjustment. The Department moved to have the issues of accumulated inefficiencies and service quality adjustment remanded for further proceedings. Subsequently, the SJC remanded for further proceedings two portions of Boston Gas' PBR plan in the Department's Orders Boston Gas Company, D.P.U. 96-50 (Phase I) (1996) and Boston Gas Company, D.P.U. 96-50-C (1997): (1) the inclusion of an "accumulated inefficiencies factor" of 1.0 percent in the productivity offset; and (2) the enlargement of the contingent annual service quality adjustment to \$4.9 million from \$1.0 million.

## II. ACCUMULATED INEFFICIENCIES FACTOR

### A. Inclusion in the PBR Formula

The Department first addresses the inclusion of an accumulated inefficiencies factor in the productivity offset used in the Company's PBR plan. The productivity offset comprised three components: (1) a historic productivity factor,<sup>(4)</sup> set at zero percent, intended to measure the difference between the natural gas utility industry and the economy as a whole in the annual increase in productivity, adjusted for the difference in the annual growth in input prices achieved in the regulated gas distribution industry from 1984 through 1994; (2) a consumer dividend, set at 0.5 percent, intended to capture the increase in annual productivity that regulated gas distribution companies are expected to achieve in the future under PBR; and (3) an accumulated inefficiencies factor, set at 1.0 percent, intended to capture the increase in annual productivity that these companies should be able to achieve during the transition period from cost-of-service regulation to PBR. D.P.U. 96-50 (Phase I) at 274-283; D.P.U. 96-50-C at 55-59.

The Company's testimony in D.P.U. 96-50 supports the underlying rationale for the movement to PBR from traditional rate-of-return regulation, i.e., that PBR will provide the Company with appropriate incentives to increase the efficiency of its operation. Boston Gas stated that, "[c]ompared to rate-of-return regulation, the PBR plan heightens the profit motive for the Company to be more efficient . . . ." (Exh. BGC-CRM-1, at 25).

The Company also stated that the "key benefits of our plan are that it affords the Company . . . the incentive to be even more innovative and efficient" (*id.*). The Company added that, "[t]he most effective regulation is competition. . . . When competition is absent, . . . performance based regulation is the preferable alternative to cost of service regulation because it more effectively simulates competitive forces" (Exh. BGC-RSB-1, at 8).

The record evidence offered by the Company therefore supports a finding that, if the average regulated firm operating under PBR will be more efficient than the average firm operating under cost-of-service regulation -- as the Company concedes -- then there must be inefficiencies embedded in the cost structure of cost-of-service regulated firms. See NYNEX Price Cap, D.P.U. 94-50, at 166-167 (1995); D.P.U. 96-50 (Phase I) at 281-282. During the early transition years from cost-of-service regulation to PBR, regulated firms have the appropriate incentives, and should be able, to eliminate the cost inefficiencies that have accumulated during the many years of cost-of-service regulation. In the absence of an accumulated inefficiencies factor, a company's ratepayers would receive none of the benefits associated with eliminating these inefficiencies. D.P.U. 96-50 (Phase I) at 282.

The Department recognizes that there is no quantitative information regarding the exact level of inefficiencies embedded in the Company's cost structures because of cost-of-service regulation. This lack of information, however, is inherent in the underlying problem. If the Department had been able to quantify this level of inefficiencies under rate-of-return regulation, we would have adjusted the Company's revenue requirement in its base-rate proceedings to eliminate these inefficiencies. In other words, if it were possible for the regulator to ferret out and quantify these inefficiencies, they would not have accumulated in the first place. In addition, as the Department stated in D.P.U. 96-50 (Phase I) at 280, there currently is little quantitative information regarding the efficiency improvements that should result as regulated gas distribution companies move from cost-of-service to PBR. However, the lack of quantitative information does not justify use of an accumulated inefficiencies factor or consumer dividend equal to zero percent, when the evidence offered by the Company in this case demonstrates that there are inefficiencies embedded in the Company's costs. The Company itself recognized this challenge when, despite the absence of quantitative information regarding future efficiency improvements, it proposed a consumer dividend equal to 0.5 percent (Exh. BGC-3, at 15-16).

The Department has reviewed our decision in D.P.U. 96-50 (Phase I) to set the accumulated inefficiencies factor for Boston Gas equal to the accumulated inefficiencies factor established for NYNEX in D.P.U. 94-50. In our Order, we stated that, because both the telecommunications and gas distribution industries have operated under cost-of-service regulation for over 100 years, the level of accumulated inefficiencies established for the telecommunications industry in D.P.U. 94-50 would represent an approximate proxy for the level of accumulated inefficiencies in the gas distribution industry. D.P.U. 96-50 (Phase I) at 282-283. Upon review, the Department has determined that directly tying the level of Boston Gas' accumulated inefficiencies to those in the telecommunications industry likely overstates the Company's accumulated inefficiencies.

As discussed in more detail below, we find that it is more appropriate to tie the level of accumulated inefficiencies to the level of the consumer dividend. For the following reasons, the Department will set Boston Gas' accumulated inefficiencies factor at 0.5 percent, which is equal to the consumer dividend factor.

In D.P.U. 94-50, the Department set NYNEX's accumulated inefficiencies factor equal to its consumer dividend. Id. at 168. It did so because the productivity increases under PBR should result from two factors: (1) the going-forward benefits associated with PBR, and (2) the elimination of the embedded inefficiencies that resulted from cost-of-service regulation during the transition. If the difference between the productivity of the economy as a whole and the telecommunications industry's annual productivity under PBR is expected to increase by 1.0 percent over the historic productivity achieved under cost-of-service regulation, then, during the transition period from cost-of-service regulation to PBR, it is appropriate to estimate that the industry's productivity increases will be twice as great as the expected going-forward increase.

The Department considers this same logic and principle to be applicable to Boston Gas' PBR plan. In D.P.U. 96-50, Boston Gas proposed a consumer dividend equal to 0.5 percent to account for the expected future increases in the gas distribution industry's productivity. The Department approved this factor in D.P.U. 96-50-C at 58. Consistent with our findings in D.P.U. 94-50, the Department concludes that the level of accumulated inefficiencies in the gas distribution industry should be set equal to the consumer dividend. Therefore, the Department finds that the appropriate value for the accumulated inefficiencies factor for the remainder of Boston Gas' current PBR term plan is 0.5 percent for Boston Gas' current PBR term. The Department directs the Company to recalculate its rates for the period February 1, 2001 through October 31, 2001 using this factor, consistent with the findings made in Section II.B, below.

#### B. Effective Date of the 0.5 Percent Accumulated Inefficiencies Factor

A fundamental rule of ratemaking is that rates are prospective in nature.<sup>(5)</sup> Narragansett Elec. Co. v. Burke, 381 A. 2d 1358 (R.I. 1977); New England Telephone Co. v. Public Util. Comm'n, 358 A.2d 1 (R.I. 1976). This rule, often referred to as the rule against retroactive ratemaking, prohibits a public utility commission from setting rates either (1) to allow a utility to recoup losses or (2) to refund to ratepayers excess utility profits. Louisiana Power & Light Co. v. Louisiana Pub. Serv Comm'n, 377 So.2d 1023, 1029 (La. 1979). The rule serves the interests of both (1) the utilities, by preventing regulators from setting rates based on hindsight, and (2) ratepayers, by denying utilities the ability to recover past deficits, also based on hindsight. Moreover, because the rule prohibits refunds when rates are too high and surcharges when rates are too low, it serves to introduce stability in the ratemaking process.

The prohibition of retroactive ratemaking is derived from the overall structure of Massachusetts law and the role of the Department in the ratemaking process. See, e.g., Newton v. D.P.U., 367 Mass. 667, 679 (1975); M.D.C. v. D.P.U., 352 Mass. 18, 23 (1967); D.P.U. v. New England Telephone and Telegraph Co., 325 Mass. 281, 289-290

(1950). Common carriers and public utilities have the right to promulgate and put into effect rates, subject to the Department's statutory right to regulate rates. D.P.U. v. New England Telephone and Telegraph Co., 325 Mass. at 289. Under Chapters 159 and 164, the Department is authorized to conduct investigations into the propriety of proposed rates and to make such orders as may be just with regards to proposed rates. G.L. c. 159, §§ 14, 18, 19, 20, 40; G.L. c. 164, §§ 93, 94, 94G; G.L. c. 165, § 2. In fixing rates, the Department must protect the right of the common carriers, the public utility companies, and their investors to an opportunity to earn a return reasonably sufficient to maintain the utility's financial integrity, as well as the consumer's right to pay reasonable rates. The statutes explicitly authorize reparations only in limited circumstances. G.L. c. 159, § 14; G.L. 164, § 94G.

The rule against retroactive ratemaking is implicated when the Department requires refunds of charges previously fixed by a formal finding that had become final. See Boston Edison Co. v. D.P.U., 375 Mass. 1, 6 (1978), M.D.C., 352 Mass. at 26. The rule, however, has no application to the facts of this case because the Department imposed rates on an interim basis pending the Department's consideration of the remand by the Supreme Judicial Court. The Department notified the Company and ratepayers on two occasions that all rates in effect during the interim period between the Court's decision and the final order in the remand proceeding may be subject to adjustment. By letter order dated October 29, 1999, the Department stated that the rates being collected by the Company commencing November 1, 1999 would be subject to revisions. Boston Gas Company, D.T.E. 99-85 (October 29, 1999). Specifically, the Department stated that it would consider the issue of whether or how the results of the remand proceeding should be applied to the D.T.E. 99-85 compliance filing in the remand proceeding. Id. at 3. The Department repeated this statement regarding rates that would be collected commencing November 1, 2000 when it conditionally approved the Company's compliance filing in D.T.E. 00-74. Boston Gas Company, D.T.E. 00-74, at 2-3 (October 31, 2000). The Department also explicitly stated that the compliance filing rates would go into effect subject to consideration of whether or how the results of the remand proceeding should be applied to the compliance filing. Id. In the absence of a final decision on the issues remanded in D.P.U. 96-50, retroactive ratemaking cannot be said to have occurred.

Allowing the tariffs filed with the Company's compliance filings to go into effect subject to revisions is consistent with the Department's treatment of similar filings in the past. In Bell Atlantic Fifth Price Cap Compliance Filing, Bell Atlantic/Verizon adjusted the productivity factor so as to increase its revenues. D.T.E. 99-102, at 1 (2000). The Department allowed proposed tariff revisions to go into effect while the Department investigated the Company's proposed productivity factor adjustment. Id. at 2. Upon the conclusion of its investigation, the Department disallowed the productivity factor adjustment and ordered Bell Atlantic/Verizon to return to ratepayers the portion of revenues associated with the disallowed adjustment as a one-time credit to customers. Id. at 18-19.

Similarly, in Bell Atlantic Fourth Price Cap Compliance Filing, the Department allowed proposed tariff revisions to go into effect while the Department investigated the

Company's proposed exogenous costs factor. D.T.E. 98-67, at 3 (1999). Upon the conclusion of its investigation, the Department disallowed the productivity factor adjustment and ordered Bell Atlantic/Verizon to return to ratepayers the portion of revenues associated with the disallowed adjustment as a one-time credit to customers. Id. at 8; see also, Boston Gas Company, D.P.U. 18264-A (1975) (allowing rates to become effective subject to refund); Blackstone Gas Company, D.P.U. 511 (1981) (requiring a revised cost of gas adjustment component that resulted in re-computations of rates previously approved); Blackstone Gas Company, D.P.U. 192 (1980) (ordering company to refund credits received from pipeline supplier); Columbia Gas Transmission Corp. v. FERC, 831 F.2d 1135, 1137 (D.C. Cir. 1987) (holding violation of the rule against retroactive ratemaking "when, without proper notice, it approved what in effect were retroactive increases in the price of natural gas previously sold by the pipelines to their customers"); Kentucky Utilities Co. v. Federal Energy Regulatory Comm'n, 760 F.2d 1321 (D.C. Cir. 1985) (stating "If the newly filed rate is eventually determined to be excessive, the Commission enjoys authority, of course, to order the utility to refund the excess portion to its ratepayers"). See generally, Krieger, The Ghost of Regulation Past, University of Illinois Law Review, 983 (1991) (reviewing variations and exceptions to the application of the traditional rule against retroactive ratemaking).

For the reasons stated in this Order and consistent with precedent, the Department finds that the effective date for the 0.5 percent accumulated inefficiencies is appropriately set at November 1, 1999. Therefore, the Department directs the Company to return to ratepayers those monies the Company over-collected from November 1, 1999 through January 31, 2001 because the Company did not include a 0.5 percent accumulated inefficiencies factor in its PBR formula during that time. The Department directs the Company to accomplish this return through a reduction in its rates for the period February 1, 2001 through October 31, 2001.

### III. SERVICE QUALITY ADJUSTMENT

The SJC also remanded the issue of the "maximum contingent service quality adjustment" applicable to Boston Gas' PBR mechanism. In its initial filing, the Company proposed a maximum penalty of up to \$1 million if it fails to maintain specified levels of customer service quality (Exh. BGC-13, at 23). The Division of Energy Resources proposed that the maximum penalty be proportional to the Company's earnings (Exh. DOER-70, at 25-26; Tr. 4, at 21). The Attorney General proposed on brief a maximum penalty of approximately \$6 million (Attorney General Brief at 9). In its Order, the Department rejected the Company's proposed penalty level as insufficient for a utility with approximately \$300 million in non-gas revenues, and established a maximum penalty of \$700,000 for each of seven service quality measures, for a total maximum penalty of \$4.9 million. D.P.U. 96-50, at 310. In setting this penalty level, the Department made it clear that it intended to set a penalty disproportionate to that approved for NYNEX in D.P.U. 94-50. D.P.U. 96-50-C at 72 (1997).

On remand, the Department emphasizes that our original decision to implement a service quality penalty different from that approved for NYNEX in D.P.U. 94-50 remains

valid.<sup>(6)</sup> However, on fresh review, the evidence in support of our decision to implement a maximum penalty of \$4.9 million is qualitative in nature. Accordingly, we have determined that there is insufficient quantitative evidence in the record supporting the use of a maximum penalty of \$4.9 million. Therefore, the Department concludes that the record evidence in D.P.U. 96-50 does not support the actual dollar amount of the \$4.9 million maximum adjustment established in the Order.

In view of the Company's success in maintaining its service quality,<sup>(7)</sup> the expiration of Boston Gas' current PBR term on November 1, 2001, and the Department's intent to apply the service quality adjustment mechanisms developed in Service Quality Standards, D.T.E. 99-84, at 43-50 (2000), to future PBR proposals,<sup>(8)</sup> the Department, as a matter of administrative convenience, declines to take further evidence on this issue. Accordingly, the Department accepts the Company's proposed maximum service quality adjustment of \$1.0 million for the remainder of Boston Gas' current PBR term.

#### IV. ORDER

Accordingly, after due notice and consideration , it is

ORDERED: That the accumulated inefficiencies factor be 0.5 percent for the remainder of Boston Gas' current PBR term; and it is

FURTHER ORDERED: That Boston Gas return the monies over-collected from November 1, 1999 through January 31, 2001 due to the absence of the 0.5 percent accumulated inefficiencies factor through a reduction in its rates for the period February 1, 2001 through October 31, 2001; and it is

FURTHER ORDERED: That the maximum service quality adjustment be \$1.0 million for the remainder of Boston Gas' current PBR term; and it is

FURTHER ORDERED: That the Company file new tariffs effective February 1, 2001 consistent with this order; and it is

FURTHER ORDERED: That the Company follow all other directives contained in this Order.

By Order of the Department,

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James Connelly, Chairman

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W. Robert Keating, Commissioner

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Paul B. Vasington, Commissioner

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Eugene J. Sullivan, Jr., Commissioner

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Deirdre K. Manning, Commissioner

1. The Company was the first gas or electric utility company in the Commonwealth to be subject to a PBR plan. Prior to the Company's filing, the Department had considered and approved a price cap plan in NYNEX Price Cap, D.P.U. 94-50 (1995).
2. Boson Gas proposed a factor of 0.1 percent: -0.4 percent historic growth; and 0.5 percent consumer dividend.
3. Boston Gas proposed a maximum annual adjustment of \$1.0 million.
4. The historic productivity factor was calculated based on data that measured both historic productivity and historic growth in input prices for gas distribution companies. D.P.U. 96-50 (Phase I) at 274.
5. Courts originally developed this rule in the context of reparation cases brought against railroad shippers who challenged the reasonableness of rates they had paid under commission-approved tariffs. See, e.g., T.R. Miller Mill Co. v. Louisville & N.R.R., 92 So. 797 (Ala. 1921), reh'g denied (Mar. 3, 1922). By analogy, the courts later applied the rule to ratemaking by public utility commissions. See, e.g., State v. Alabama Pub. Serv. Comm'n, 307 So.2d 521, 539-40 (Ala. 1975).
6. It is self-evident that service quality failures for a gas utility may carry greater consequences than those of a telephone company, as illustrated by the effect of a gas main explosion versus dial tone failure. Hence, a greater penalty in proportion to a utility's revenues is warranted in situations where public safety considerations exist.
7. No monetary penalties were necessary in the Company's three most recent PBR compliance filings. Boston Gas Company, D.T.E. 00-74 (2000); Boston Gas Company, D.T.E. 99-85 (1999); Boston Gas Company, D.T.E. 98-98 (1998). A service appointment adjustment of \$140,000 was imposed in Boston Gas Company, D.T.E. 97-92, at 8 (1997). As noted by the Department in D.T.E. 99-84, utilities that conduct their business in a manner which maintains service quality measures may avoid adjustments completely. Service Quality Standards, D.T.E. 99-84, at 49 n.37 (2000). Therefore, companies which internalize an ethic of providing quality service to their customers have little, if any, need to be concerned with revenue adjustments.
8. General Laws c. 164, § 1E(c) authorizes the Department to levy a penalty against any distribution, transmission, or gas company that fails to meet the service quality standards established under G.L. c. 164, § 1E(a) up to and including the equivalent of two percent of a utility company's transmission and distribution service revenues for the previous calendar year. Service Quality Standards, D.T.E. 99-84, at 40 (2000).